market notes: The grumpy trader…in a rising market

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10/27/23 - Marcel Kasumovich, Deputy CIO, Coinbase Asset Management

1. "You are really going to love this." Sarah printed me an academic paper on how moods influence decisions. Happy people are more optimistic, and sad folks pessimistic, in making decisions around the same events with the same uncertainty. It was published in 1992 – Sarah isn't one to chase fads, hunting for ways to imprint her quantitative mind to systematic portfolios. And knows her team well enough to fire them up.
2. Self-evident, you may surmise. I thought the same initially. But like any great work, it's the subtlety that matters. Decision-makers are largely unaware of their mood bias, and their decisions can have a material impact on outcomes. It's not that happy people make positive outcomes more likely, either. Au contraire. The unsuspecting optimist may inappropriately reduce the complexity of a problem to align with their bias, ease the burden of their decision.
3. Who cares? Well, cognitive bias is at the core of financial market behavior. Biases define boom-bust cycles. Rational discourse is replaced by irrational exuberance for long periods. The best quantitative strategies find ways to account for these experiences, integrating them into risk management. Quantifying them in a systematic manner builds a process that lessens the role of our moods. It's the perfect tool for the grumpy trader.
4. What does this have to do with today's markets? Nothing, and everything all at once. We have worked tirelessly on building **natively digital infrastructure** to allow for active trading, index rebalancing, and credit. It's a different beast than traditional markets – there is no centralized intermediary intervening to smooth markets nor are there circuit-breakers to give traders time to breathe. Fast-moving markets put that infrastructure to the test. Like the past weekend.
5. What did we learn? **It works.**
6. Our Monday morning meetings focus on market updates. Like a jazz ensemble, there is just enough structure to know who's playing next, but the audience is never quite sure what tune. It was a busy weekend for Sarah's systematic Digital Trend Strategy. Heading into last weekend, the model was nibbling on long exposure. By Monday morning, the strategy had a very different appetite. Low conviction was long gone, replaced over the weekend by a clear risk appetite to be long. It's a "go-with" trend.
7. Such is a day-in-the-life of crypto asset markets. The infrastructure must be flexible enough to capture the cadence of the market – any time and any place. Sarah patiently explained how it works, walking the team through each step. Her trading bot alerts the team to when the model is readying to trade, and a human touch is used to ensure everything is executed as it should. Data on every last detail is available at her fingertips.

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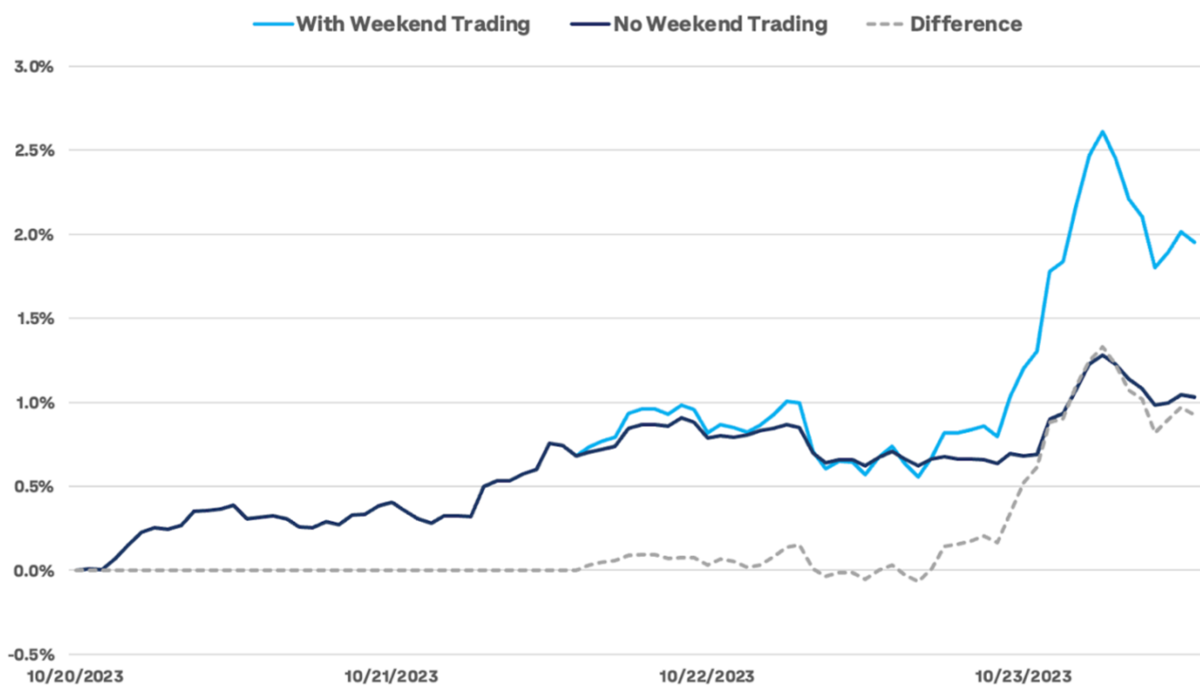
8. Is it worth it? Think about it two ways. The first is narrow – the value added from trading weekends. Figure 1 shows the difference between active trading versus not trading last weekend – the gap was ~100 basis points, a substantial capture of bitcoin's rise. The second is broad – a holistic evaluation, not history, is the right judge. Trading in counter-trend moves is critical to risk management and can be orders of magnitude greater than last weekend's move. The infrastructure can't fail you then.

9. All of this is interesting in the context of the recent move in markets, centered on excitement around a US Bitcoin spot ETF. To be sure, the ETF is symbolic of the pent-up demand from traditional investors to enter crypto markets. But it's also not ideal. Own bitcoin directly and you can decide whether or not to trade any time, any place. Own the spot ETF and you are long a note subject to the limitations of traditional markets. The ETF is merely a gateway, a transition to onchain asset management.

10. There is also an interesting twist in cross-market correlations. Weekend events can bring activity trapped by untradeable traditional markets onto crypto rails. What might that look like? This is where cognitive biases really muddy the waters. Experts like IMF economists argue that 80% of crypto asset volatility can be explained by a single factor, dominated by equity markets. You wouldn't know it in the past week, with crypto asset markets rising double-digits and global equity markets under downward pressure.

11. There's always more to the story. Right when you think you have identified stable market relationships, correlations shift to teach you the lesson. Higher US real yields aren't generating a rapid rise in the US dollar nor a decline in commodity markets as would typically be the case. Banks are again strained despite low unemployment. The grumpy trader sees more work to be done and wants to find ways of accounting for biases in trading, taking moods out of the equation. Because building never stops.

Figure 1 – To Trade or Not to Trade? Trend Strategy, Weekend Warrior



Source: Coinbase Asset Management. Coinbase Digital Trend Performance from 10/20/2023 UTC to 10/23/2023 UTC. The estimated difference due to weekend trading should be viewed as the value-add net of fees. [1]

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